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Misapplied accounting idles two machines while others work overtime . . .

HOW "ALL-PURPOSE" DATA C

by Robert G. Stevens, Ph.D.

Detroit

LIKE MANY OF OUR CLIENTS, the XYZ Company re-evaluated its burden rates once each year. These burden rates were of the full-absorption variety and based on estimated volumes as opposed to practical capacity or normal volumes. Therefore, when volume estimates were low, burden rates were high. If the estimates went up, the rates would go down.

In their particular industry it was customary to issue bids or quotes on business, and their cost estimating department was charged with this responsibility. The cost of a particular item was established by analyzing blueprints to determine material requirements and to determine the manufacturing operations which would be required to fabricate the part. The estimated time required to perform each operation was determined by reference to engineering standards or historical data concerning past performance on similar products. Direct labor rates and the absorption burden rates for the various operations were supplied by the accounting department.

These cost estimates provided a basis for determining selling price and also became a basis for preparing shop orders. Then the sales department established the final selling price by adding a standard markup. Some orders would be reviewed by the sales executive and the standard markup might be adjusted to meet market conditions or the quotation might be referred back to cost estimating to explore the possibility of a more economical way to fabricate the product.

AUTHOR STEVENS received his B.S. degree from Southern Illinois University in 1951 and was a first lieutenant in the Air Force until 1953. He then entered the University of Illinois, earning his M.S. in 1954 and a Ph.D. in 1958. Mr. Stevens joined TRB&S later that year.

EFEAT GOOD MANAGEMENT

Costs Seem to Rise for Two Machines . . .

In 1958 it was estimated that there would be relatively little demand for the quality of product which could be made on Press III, and only a small volume of work was anticipated which would be adaptable to the automatic saw operation. Since certain fixed costs were both directly related and allocated to these operations, the absorption burden rate was considerably higher than that in previous years and also higher than the 1958 rates for similar operations which were based on more "normal" volume forecasts.

When the first quotations involving these operations went through, the standard selling price was obviously not one that customers would pay. Investigation resulted in the sales department questioning the new burden rates for Press III and automatic sawing. But the discussions with Accounting only convinced them that the new burden rates did reflect the actual costs of these operations. Profits on individual jobs would also be determined and reported on the basis of these burden rates. They certainly did not want to sell anything below cost or to look bad on sales reports.

. . . So These Machines Stand Idle

The obvious answer was simply to avoid the use of these operations. The cost estimating department, therefore, assigned orders to hand saw instead of automatic saw. Presses I and II were used in preference to Press III. The manufacturing and production scheduling departments were also convinced that these were high cost operations. As was customary, they fabricated jobs in conformity with the operations indicated by the cost estimating work sheets. As a result, very little work was done on the automatic saws, the Press III area was used for storage space and, worst of all, overtime and night-shift premiums were paid to the crews of Presses I and II to keep up with the work load.

Contrary to what some might conclude, the management of the XYZ Company is exceptionally competent. Many companies make no effort at all to relate production scheduling to production costs.

This is a case in which good management was misguided by a poor application of accounting. The data used were acceptable for purposes of income determination but were not valid for this operating decision. Data developed under the concepts of Profitability Accounting, however, were valid. Under a new system of accounting, the cost estimating department is concerned only with the variable costs of manufacturing operation.

These variable costs provide a valid basis for determining the least-cost combination of operations required to fabricate a particular product. The absorption of fixed cost is considered a function of determining periodic income, and adjustments are made to arrive at balance sheet values for inventories which are consistent with generally accepted accounting principles. Fixed costs are also important in break-even analysis, and they are given proper consideration in cost control and in pricing.

The Need for Data Is So Great

It is safe to say that almost all accounting data in existence today are intended for the specific purpose of preparing balance sheets and income statements. These same data are probably being used for an infinite number of diverse purposes because there is such a great need for data. Accounting is a powerful force. Its apparent preciseness instills confidence, and very few who use accounting data are in a position to refute its validity. What happened to the management of the XYZ Company is probably happening to the management of many companies today.